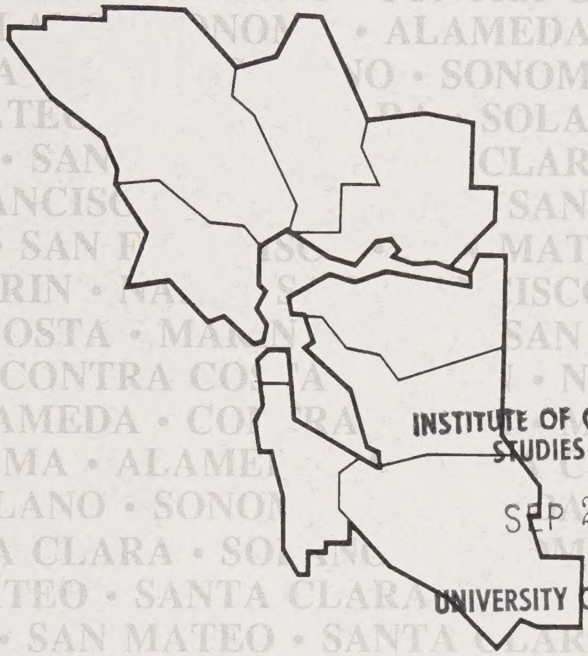
PROFILING THE IMPACT OF CORPORATE RESTRUCTURING ON THE BAY AREA ECONOMY



Bay Area Council

Final Report
June 9, 1987

McKinsey & Company, Inc.

87 01930

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This report was approved by the Bay Area Council Executive Committee on June 9, 1987, as recommended by the Council's Mergers and Acquisitions Task Force.

MERGERS AND ACQUISITIONS TASK FORCE

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EXECUTIVE SUMMARY

The merger and acquisition phenomenon has been singled out recently as evidence of the perceived decline of San Francisco as a business center. Television documentaries and magazine reports have focused on the apparent ease with which outsiders have taken over corporations in the region. The drama of corporate acquisition has even led some to the conclusion that the Bay Area is slipping irreversibly into economic uncompetitiveness.

At first glance there seems ample cause for concern. Between 1979 and 1986, 110 corporate restructuring transactions of greater than $50 million in value occurred in the Bay Area. By the end of 1986, 17 of the 32 Fortune-500 equivalent corporations in the Bay Area in 1979 had been eliminated from the publicly-owned list because of mergers, acquisitions, and leveraged buyouts. Recently the pace of merger and acquisition activity has quickened. During 1985 and 1986 the annual rate of occurrence of Bay Area acquisitions was about double the average annual rate between 1979 and 1984.

In October of 1986, the Bay Area Council commissioned a Task Force from among its members to look into this issue. At about the same time, the partners in the San Francisco office of McKinsey & Company, Inc., a general management consulting firm, began to explore the effect of corporate restructuring on the economic health and future of the Bay Area. Shortly thereafter, McKinsey agreed to join the Task Force in a study of the issue, on a pro bono basis.

Our approach was to examine the facts about corporate restructuring in order to assess its impact as objectively as possible. To guide the analysis, the Task Force began with four questions:

¶ What is the record of restructuring in the Bay Area?

¶ Have restructurings significantly harmed the region to date?

¶ Will the economic impact of restructurings worsen in the future?

¶ What influence can public or private initiatives have over the nature or results of restructurings?

For the purposes of this report we define corporate restructuring as hostile or friendly acquisitions, mergers, leveraged buyouts, and major divestitures — but not reorganizations, expansions, work force reductions, or cost reductions resulting from ongoing operations.

This executive summary reviews the Task Force's initial findings and explains how the information we found caused us to refocus our view of the issues. A brief report of our examination of restructuring in a broader economic context follows. We conclude with a list of further questions brought to light by this inquiry — questions that will be important in forming a new public agenda to deal with the future of economic growth in the Bay Area.

THE FINDINGS

The facts regarding the record of corporate restructuring in the 9-county Bay Area, and the economic impact directly attributable to it, turn out to be somewhat surprising given the perspectives that led to the study:

¶ The Bay Area's restructuring experience over the past seven years has been far more complex than generally recognized:

- Hostile takeovers, while certainly important, are only part of the story. Voluntary mergers and acquisitions have been common as well.

- Acquisitions initiated by Bay Area firms have represented 40 percent of the restructuring activity in the region.

¶ Direct negative effects on the economy from corporate restructuring (as distinguished from downturns due to the normal course of business) have been surprisingly limited:

- Aggregate job loss has been relatively small: about 36,000 jobs were eliminated directly and indirectly because of restructuring between 1979 and 1986, but 600,000 jobs were added in the region during the same period.

- The Bay Area economy has been more than strong enough to absorb the negative impact of corporate restructuring. For example, although 17 *Fortune*-500 equivalent firms dropped from public ownership between 1979 and 1986 due to restructuring, a net total of 21 other Bay Area firms grew to this rank during the same period.

¶ However, while the overall regional economy has been extremely healthy for a considerable period of time, San Francisco's restructuring experience has been more negative than that of the region in general:

- San Francisco has taken the brunt of the departure of the area's Fortune-ranked headquarters.

- Partly as a result of restructuring, San Francisco job growth has slowed since 1980.

- Corporate leadership in Bay Area charitable and civic activities has eroded in San Francisco, as restructuring has affected some of San Francisco's oldest firms.

The uneven impact of restructuring on San Francisco's older, major firms raised the issue of the connection between individual restructuring transactions and patterns of change in the U.S. economy as a whole. Upon examination, corporate restructuring appears to be a mechanism and symptom of larger forces at work in our economy, not a primary cause of change in and of itself. Moreover, some of the positive aspects of restructuring have benefited the Bay Area:

¶ Restructuring reflects the "market for control" of corporations and functions as one way of redirecting corporate assets to their most productive use:

  - The right to control corporations has always rested ultimately with stockholders, but recently it has been asserted more often.

  - Despite imperfections, restructuring is a tool for stockholders to redeploy corporate resources, especially in mature industries and in cases where management's investment decisions are judged to be inappropriate.

¶ In the Bay Area, as elsewhere, restructuring has functioned in part as an agent of beneficial economic renewal:

  - Restructuring among the Bay Area's mature businesses has generally reflected nationwide patterns of economic change, not regional peculiarities.

  - Some major Bay Area firms are stronger as a result of restructuring.

  - The ability to restructure is essential for the venture capital and investment banking industries to assist the growth of smaller firms, e.g., those in the high-technology sector so important to the Bay Area's economy.

Because restructuring functions in complex ways, its impact depends strongly on the particular circumstances of individual transactions, which in turn are imbedded in the competitive conditions of all the industries involved. As a consequence, it is impossible to predict whether the net effect of restructuring as a whole will have positive or negative consequences for the future of the Bay Area economy.

It is a virtual certainty that corporate restructuring will continue here as elsewhere, but it will be driven by the U.S. and world economies and brought into play by the performance of individual firms. We see no reason why local companies should be disproportionately affected by these broader trends. By the same token we do not expect them to be exempt from the business cycle of birth, growth, maturity, and decline.

PUBLIC POLICY IMPLICATIONS

What, if anything, should be done about corporate restructuring? Our study has led the Task Force to conclude that — despite widespread anxiety and continual media attention — the corporate restructuring issue will not be a productive focus for local public policy. It is a national phenomenon, the philosophical and practical ramifications of which cannot be addressed at the local level.

Although concerted public initiatives may occasionally deflect acquisitions of local corporations, the effort required to rally a constituency is enormous, and has no guarantee of long-term success. However well motivated, such campaigns pursue the symptoms of economic activity rather than the very strong forces of growth and change underlying them, and they would have to be mounted time after time. As a general policy, it seems unwise and futile to attempt to protect Bay Area businesses from restructuring.

Mergers and acquisitions have distracted public awareness from more fundamental questions about the Bay Area economy. Restructuring is neither the core issue facing Bay Area businesses, nor one that can reliably be influenced by local initiative. Consequently, priorities for study and action on the regional economy must be changed.

THE CHALLENGES AHEAD

The key challenge will be to sustain economic vitality in an increasingly competitive and interlinked national and world economy.

The Task Force's study of restructuring raises a number of questions that may contribute to this new, more fundamental economic agenda. These questions are a starting point for efforts to understand the dynamics of the Bay Area economy better and to explore which public and private actions — if any — could effectively enhance regional economic vitality.

It is ironic that political and business leaders in the region have grown so accustomed to the area's strong economic performance in the past two decades that, like the California sunshine, this economic base is generally taken for granted. Partly as a consequence, the primary public concern has been to mitigate the impact of economic growth, rather than to understand and nurture the conditions that make economic growth possible.

Thus, for those concerned with the Bay Area economy, the immediate tasks are to increase the prominence of economic issues on public and business agendas, to broaden and elevate the level of debate, and to enable dialogue on a regional scale.

Among the fundamental issues that should frame such discussions are:

¶ What are the likely future directions for the region's economy:

- What are the foreseeable trends in major industry groups?
- What market, political, and public policy factors will affect the future economic structure of the Bay Area?

¶ What are the critical economic interrelationships within the region:

- How will San Francisco's economic performance affect the Bay Area as a whole? To what extent do national perceptions of San Francisco's business and political climate color other areas of the region?
- To what extent could a renewed base of San Francisco corporations serving national and international markets help support the growth of smaller and service-based businesses throughout the region?
- Will the Bay Area's economic base become increasingly dependent on the high-technology industry centered in Santa Clara County? If so, what are the implications for the region?
- How can corporate leadership in civic affairs be renewed and broadened both substantively and geographically?

¶ Can a regional approach to economic development be successful?

- Is there a sufficient commonality of economic interest to engage parts of the region in addressing a regional economic development agenda?

- How can regional political and corporate leadership be developed to overcome parochial interests and perspectives?

- Is there enough interest in both the public and private sectors to mount an effective and sustained effort?

Economic success stories from other areas of the nation suggest that well informed efforts of business, government, and the public can indeed result in tangible progress toward regional economic goals. For the Bay Area's community and business leaders, the first step is to begin a broad-gauged debate about the Bay Area's economic future. Only then can a realistic, regionally based program of action emerge.

* * *

What follows is a more detailed review of the Task Force's findings and conclusions. It is organized into five major areas:

¶ <u>The record of corporate restructuring</u>: an examination of restructuring transactions revealing Bay Area firms as both targets and acquirers

¶ <u>The limited impact of restructuring</u>: a discussion of the relatively minor net effect restructuring has had on the Bay Area economy

¶ <u>The pressure on San Francisco</u>: a review of the special challenges faced by San Francisco as a result of restructuring

¶ <u>Restructuring as a natural economic process</u>: a broad view of the role of corporate restructuring in the national economy and how this has played out in the Bay Area

¶ <u>The need for a new economic agenda</u>: a discussion of the kinds of questions that may help focus future public debate.

TASK FORCE FINDINGS AND CONCLUSIONS

THE RECORD OF RESTRUCTURING

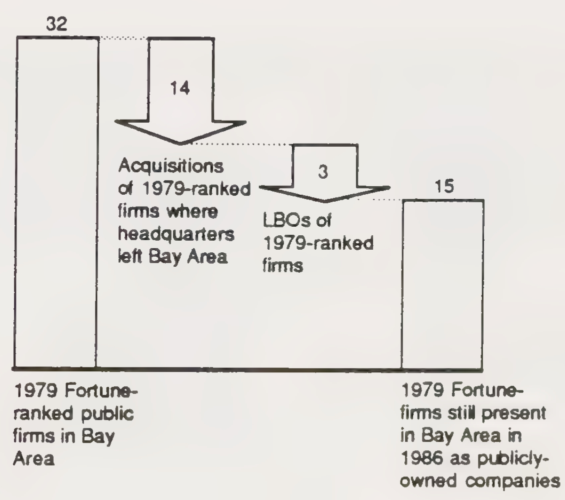
The conventional image of corporate restructuring is the takeover. The fear is that ownership changes among independent, publicly-owned, large, locally headquartered firms will do grave harm to the economy of the region — by removing the source of corporate power beyond the reach of community influence, by encouraging new management to shut down facilities, fire workers, and so on. This type of restructuring also receives the most publicity, so the overall impression tends to reinforce itself.

Ownership change of this sort among large Bay Area firms has been substantial and sobering, if we take the history of the local Fortune-500 ranked firms as a proxy for the top of the economic pyramid (Exhibit 1). From 1979, when corporate restructuring began to be relatively frequent in the region, to 1986, such famous Bay Area Fortune-rank firms as Crown Zellerbach, Memorex, and

Exhibit 1

CHANGE IN BAY AREA'S FORTUNE 500-EQUIVALENT FIRMS – 1979-86*

Number of firms



* Includes only those firms ranked in 1979

Source: Fortune; telephone interviews; McKinsey analysis

Exhibit 2

CORPORATE RESTRUCTURING AMONG BAY AREA FORTUNE 500-EQUIVALENT FIRMS*

INDUSTRIALS		
1979	Del Monte	Acquired by R.J. Reynolds
1981	Memorex	Acquired by Burroughs
1982	Arcata	LBO
	Castle & Cooke	Acquired by Murdoch group
	Envirotech	Acquired by Baker International
	Kaiser Steel	Acquired by Perma Group
1985	Levi Strauss	LBO
1986	Crown Zellerbach	Acquired by Sir James Goldsmith, et. al.
	Genstar	Acquired by Imasco

FINANCIAL SERVICES		
1979	United Financial of California	Acquired by National Steel
1982	Dean Witter Reynold	Acquired by Sears
	Northern California S&L	Acquired by Great Western
1986	Crocker National	Acquired by Wells Fargo

RETAIL		
1986	Safeway	LBO

TRANSPORTATION AND UTILITIES		
1983	Natomas	Acquired by Diamond Shamrock
	Southern Pacific	Acquired by Santa Fe

OTHER		
1986	Saga	Acquired by Marriott

* Includes only those firms ranked in 1979

Source: Fortune; annual reports; interviews; McKinsey analysis

Exhibit 3

TYPES OF CHANGE IN CORPORATE OWNERSHIP

Change in structure	Characteristics	Local example
Merger	– Usually voluntary, between corporations	Wells/Crocker
Acquisition	– Often involuntary, via tender offer	Goldsmith/Crown Zellerbach
Leveraged buyout	– Usually voluntary, via debt held by management or stockholder group	Levi Strauss

Southern Pacific were acquired by interests from outside the region (Exhibit 2). Other examples include Rolm, which gained Fortune rank in 1983 but was acquired by IBM in 1984. In some cases, the headquarters of these companies have been transferred out of the region. In others, independent corporate presence has been severely reduced in scope.

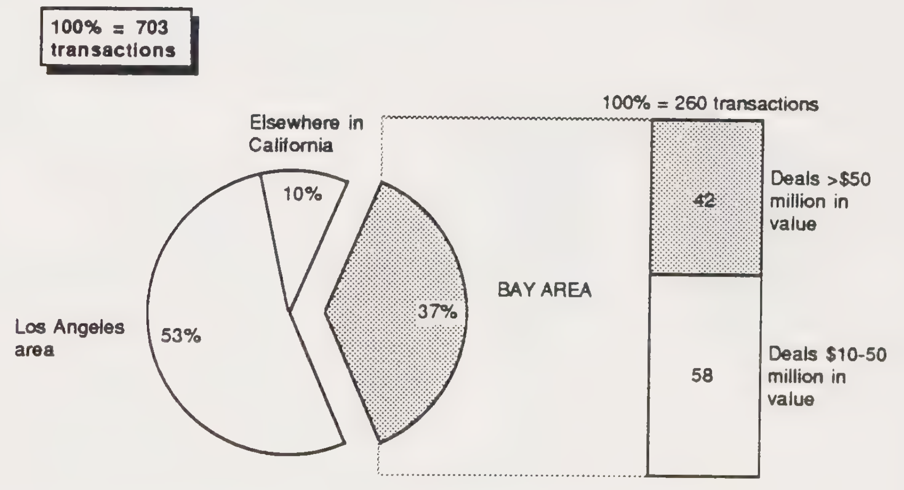
However, corporate restructuring is not limited to hostile takeovers of large corporations (Exhibit 3). To be accurate, a full picture of change in corporate ownership must include voluntary mergers, leveraged buyouts, divestments and spinoffs, and various technical changes having little effect on ongoing operations. For example, three of the Fortune-ranked companies experienced leveraged buyouts, which — as the cases of Levi Strauss and Safeway demonstrate — do not necessarily entail loss of local presence.

To examine corporate restructuring in this broader sense, we compiled a database of 703 separate transactions, each valued at $10 million or greater, which were concluded in California between 1979 and late 1986. These transactions totalled to more than $130 billion. Some 260 of them involved Bay Area firms, of which 110 were large transactions valued at $50 million or more (Exhibit 4).

Exhibit 4

CORPORATE RESTRUCTURING DATABASE – 1979-86

Percent



Source: Mergers & Acquisitions database; telephone interviews; McKinsey analysis

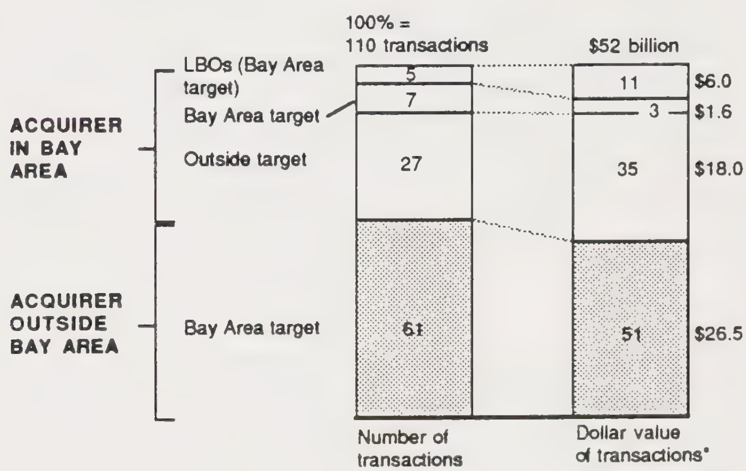
We excluded from this database all cases of "reorganization" due to ongoing operations rather than change in ownership. Because of the job impact, the word restructuring is often understood to include long-term layoffs, permanent reductions in work force, or programs to relocate employees, even though no ownership change as such is involved. Such cost-reduction moves sometimes are undertaken to fend off acquisition threats. However, far more often they are economically motivated responses to competition — responses that might well have been appropriate even in the absence of external threats but in any case were decisions taken in the normal course of business.

Inspection of the full record of restructuring substantially modifies the common view identifying all corporate ownership change with hostile takeovers. Only 61 percent of the large-firm transactions were takeovers launched from outside (Exhibit 5). The other side of the coin is that almost 40 percent of the large restructurings were initiated by Bay Area businesses, including intraregional transactions and leveraged buyouts. Bay Area-driven transactions accounted for almost half the total dollar value of changes in corporate ownership between 1979 and 1986.

Exhibit 5

BAY AREA RESTRUCTURING ACTIVITY – 1979-86

Percent of transactions greater than $50 million



* No dollar value disclosed for seven transactions

Source: Mergers & Acquisitions database; telephone interviews; McKinsey analysis

It is worthwhile, furthermore, to consider the varying impact that the different sorts of restructuring can have. In instances when Bay Area firms have initiated takeovers of outside firms — such as the very large acquisition of Gulf Oil by Chevron in 1984 — the regional economy is almost certainly better off as a result. In cases where one local firm has acquired interests in another — as, for example, the Bank of America's acquisition of Charles Schwab Discount Brokerage in 1983 and subsequent divestiture in 1986, or American President Companies' purchase of part of Brae in 1985 — there is at least a substantial chance that the regional economy will experience a net gain rather than loss. Sometimes gains take place through the creation of incremental jobs. In other instances, restructuring may help sustain the acquirer as an ongoing entity less vulnerable to future competition. Finally, even outside takeovers do not necessarily harm the local economy. The acquisition of Hibernia Bancshares Corporation by First Pacific Holdings (1983), for example, has if anything enhanced its role in the regional economy, by strengthening its capital base and introducing new sources of added value, through people and through fresh visions of business strategy.

THE LIMITED IMPACT OF RESTRUCTURING

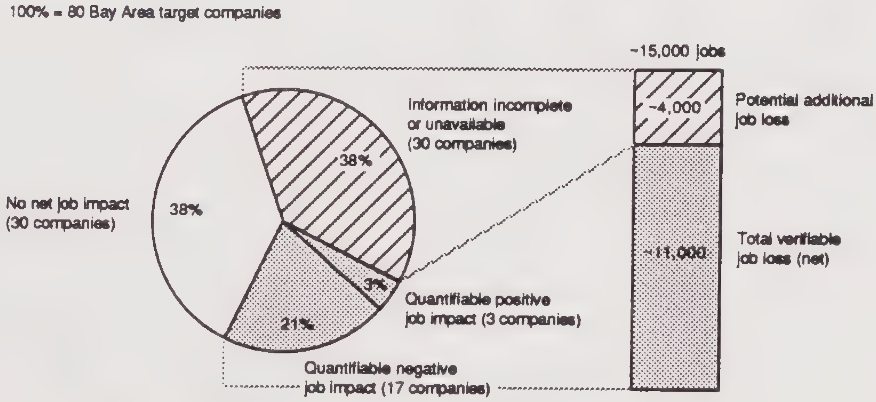
Net loss of Bay Area employment due to corporate restructuring appears to have been relatively small over the past 7 years. During that period, approximately 11,000 jobs can be confirmed as lost in the region directly as a result of restructuring. These losses occurred in only about 20 percent of the transactions involving Bay Area target companies. Unfortunately it is impossible to obtain complete and precise information on this key subject, particularly with regard to smaller transactions. To allow for those cases where public information is unreliable, we estimate that another 4,000 jobs may have been lost, making a total of about 15,000 jobs directly eliminated because of corporate restructuring (Exhibit 6).

The indirect job loss in companies serving the larger acquired corporations (the ripple effect) is likely to have been somewhat greater than direct job loss. We estimate that approximately 1.4 jobs were lost in support business and professional services, finance, insurance, commercial real estate, etc., for each job lost directly.[1] Thus corporate restructuring appears to have displaced approximately 36,000 jobs, directly or indirectly, in the Bay Area over the 7-year period.

To understand the relative impact of these figures, we must compare them with the strong record of job growth in the Bay Area. The local economy has been very robust, creating about 600,000 jobs between 1979 and 1986 — a far greater number than the 36,000 eliminated during the same 7-year period because of

Exhibit 6

BAY AREA JOB IMPACT DUE TO RESTRUCTURINGS – 1979-86*



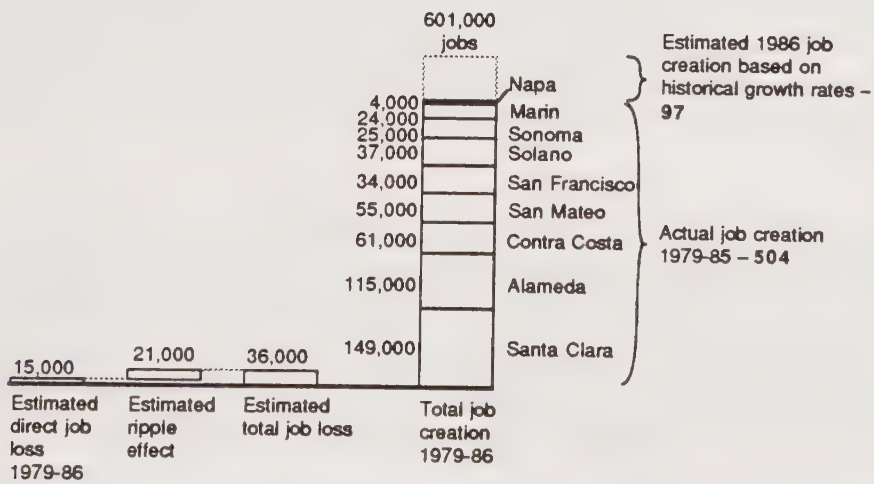
* 80 transactions of $50 million or greater

Source: Telephone interviews; newspaper articles; McKinsey analysis

Exhibit 7

AGGREGATE IMPACT OF RESTRUCTURING ON BAY AREA JOBS – 1979-86

Number of jobs

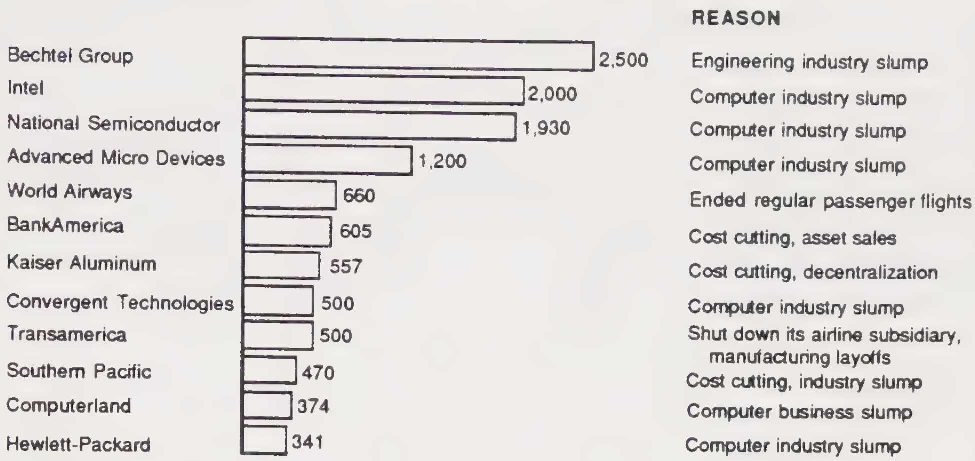


Source: California Employment Development Department; McKinsey analysis

Exhibit 8

LARGEST CUTS IN BAY AREA JOBS DUE TO INDUSTRY CONDITIONS – 1985-86*

Number of jobs eliminated



* As of October 27, 1986

Source: The San Francisco Chronicle

corporate restructuring (Exhibit 7).

No job loss is insignificant to those directly affected. We do not minimize the impact of lost jobs on individual Bay Area workers, their families, and their communities. But when we look for general economic trends, we must compare the loss of these 15,000 jobs to cutbacks in firms trying to persevere as independent entities against severe competition. As an illustration of this point, nearly 12,000 jobs were reported lost at major Bay Area corporations in 1985 and 1986 alone, because of intensely competitive conditions in various industries (Exhibit 8). This figure approaches the direct job loss due to restructuring over the entire 7-year period. Furthermore, although restructuring may have caused job opportunities to be lost, it is far from certain that all the displaced jobholders were forced into leaving the area or becoming chronically unemployed. Finally, over 35 percent of the large corporate restructurings did not result in quantifiable job loss at all.

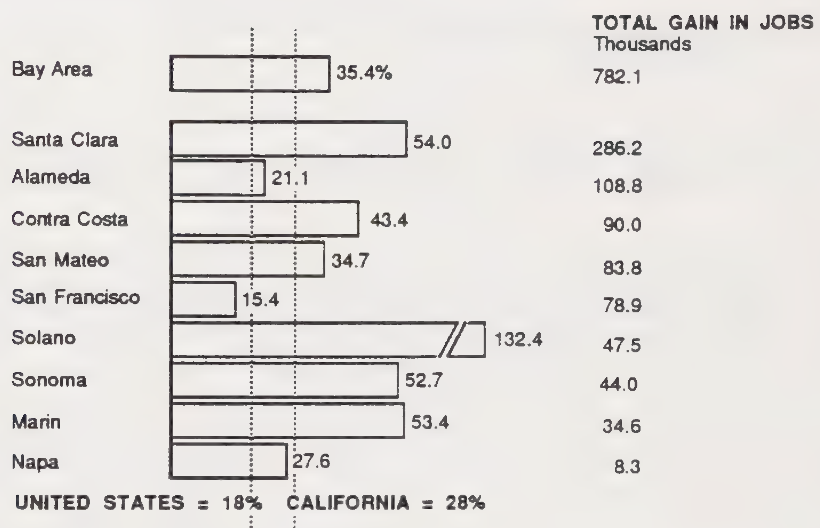
Direct losses in tax revenue due to corporate restructuring also appear to have been relatively limited. We examined San Francisco County as a case study to gauge the tax impact of restructuring. Among the various direct sources of County tax revenues, only the business tax appears to have been measurably affected by corporate restructuring — and this at a rate equivalent to merely 0.4 percent of

the City and County's 1985 revenue of $550 million. On the basis of this sample, changes in corporate ownership per se would appear to have relatively little discernible adverse impact on property tax, sales tax, or other local tax revenues.

The larger context for the regional experience of corporate restructuring is the general state of the Bay Area economy. In recent years, its performance has been very good. Compared to the United States as a whole, both the state and the region have enjoyed a substantially higher employment growth rate during the past decade. All the Bay Area counties individually have outperformed California and the United States in the rate of employment growth, except Alameda and San Francisco counties (Exhibit 9). Projections are for continued strong regional employment growth of about 56,000 jobs annually until the year 2005.[2]

Exhibit 9

BAY AREA CHANGE IN TOTAL EMPLOYMENT – 1976-85
Percent

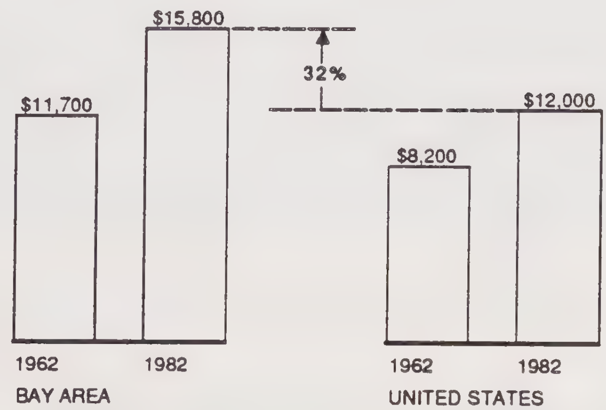


Source: California Employment Development Department

As a consequence, the Bay Area has provided extraordinary opportunities to those wishing to work. In the mid-1980s, local unemployment has been 1.5 to 2 percentage points less than the national average. Over the past 20 years, per capita real income levels in the Bay Area have remained significantly higher than those of the nation at large (Exhibit 10).

Exhibit 10

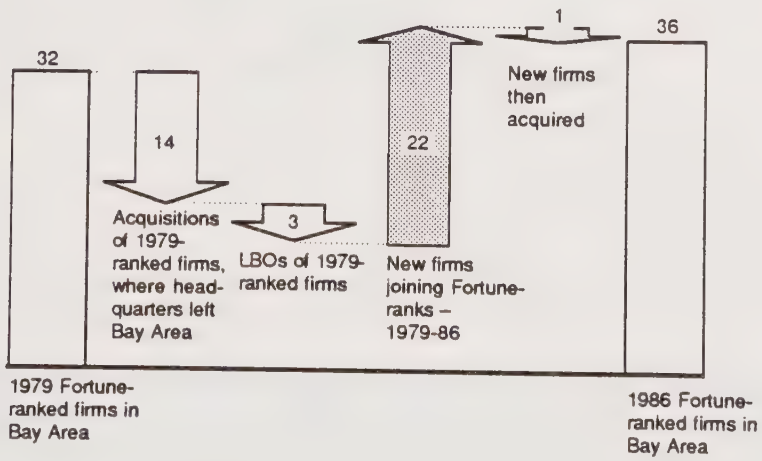
PER CAPITA INCOME GROWTH IN THE BAY AREA
1984 constant dollars



Source: Association of Bay Area Governments; U.S. Department of Commerce; U.S. Bureau of the Census

Exhibit 11

CHANGE IN BAY AREA'S FORTUNE 500-EQUIVALENT FIRMS
Number of firms – 1979-86



Source: Fortune; telephone interviews; McKinsey analysis

Exhibit 12

FIRMS JOINING FORTUNE-EQUIVALENT RANKS – 1979-86

INDUSTRIALS
- Advanced Microdevices
- Amdahl
- Apple Computer
- California and Hawaiian Sugar
- Clorox
- Cooper Labs/CooperVision
- Kaiser Aluminum and Chemical
- Liquid Air
- Raychem
- Rolm
- Tandem Computer
- Xidex

FINANCIAL SERVICES
- Fireman's Fund
- Homestead Financial
- U.S. Leasing

DIVERSIFIED SERVICES
- Amfac
- DiGiorgio
- Guy F. Atkinson
- Longs Drugs
- McKesson

TRANSPORTATION / UTILITIES
- American President Companies
- Pacific Telesis

Source: Fortune; telephone interviews; McKinsey analysis

In the present context, the most compelling sign of the vitality of the region's economy is the growth of local firms to Fortune-500 equivalent rank. During the same period that 17 Bay Area firms lost this status (without necessarily ceasing to play a role in the local economy), a net total of 21 companies joined the Fortune-equivalent list as independent, publicly owned, and locally headquartered corporations (Exhibits 11 and 12). We are seeing a natural economic process — the decline of mature companies that have been unable to renew themselves and remain vital and competitive, along with the rise of innovative firms that can respond to changing conditions and manage effectively.

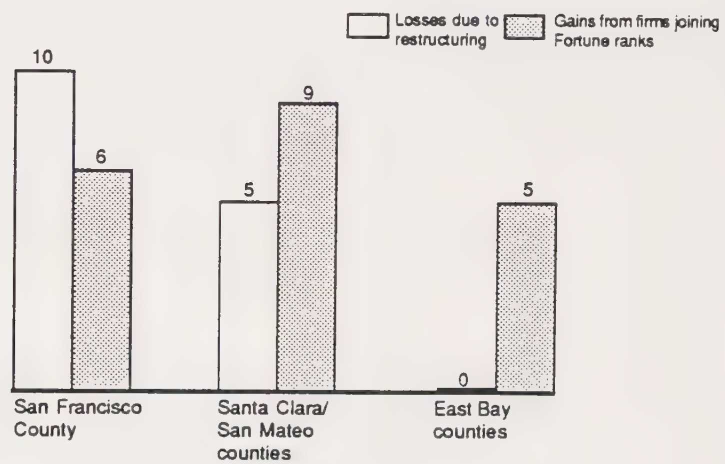
THE PRESSURE ON SAN FRANCISCO

All in all, viewed against the generally healthy state of the Bay Area's economy, the impact of change in corporate ownership during the past 7 years appears to have been less negative than many have intuitively believed. However, this is less true of San Francisco than of the Bay Area as a whole — a fact that raises serious issues about the interrelationship of the city and the regional economy.

As a historical hub in the Bay Area region, San Francisco does seem to have

suffered from its recent history of corporate restructuring. San Francisco County has taken the brunt of the departure of Fortune-500 level companies from the Bay Area (Exhibit 13). Moreover, since 1980 the concentration in San Francisco of mature industries has not only increased the likelihood of restructuring activity, it has also contributed to the significant slowing of job growth in all sectors, except trade and general services. In particular, according to the San Francisco Chamber of Commerce, manufacturing, durable goods, financial services, transport and utilities, and construction all showed negative growth between 1980 and 1984.

Exhibit 13
MAJOR BAY AREA CORPORATE HEADQUARTERS GAINS AND LOSSES – 1979-86



Source: Fortune; telephone interviews; McKinsey analysis

The well known recent economic shifts toward concentration in high technology, particularly in Santa Clara and San Mateo counties, have implications for the Bay Area economy as an overall system.[3] To the extent that these shifts have constituted a significant part of regional growth, they are welcome developments. To the extent they have imperceptibly shifted the economic center of gravity away from San Francisco, they highlight the relatively high level of restructuring pressure on the City. While San Francisco County was a net loser of Fortune-level company headquarters due to restructuring between 1979 and 1986, the South Bay (Santa Clara and San Mateo counties) and East Bay gained.

Moreover, the continued presence of a critical mass of sizable corporate headquarters provides advantages beyond economic returns. Some of these, like civic pride and prestige or the general level of business hustle, are hard to measure directly. Yet they remain important and, as our interviews indicated, erosion of this base has become a widespread concern of the San Francisco business community.

Corporate headquarters give money and donate executive time, fundraising contacts, organizational talent, and advice to many cultural and charitable organizations. Corporate workers also donate to and work for the same causes. Loss of corporate headquarters implies fewer dollars and less support for social and cultural services.

In 1986, a major San Francisco charitable organization experienced a 5 percent decrease in corporate donations entirely because of headquarters changes due to restructuring. In general, City cultural organizations have had to scramble to maintain parity with previous years' donations.[4] Interviews with executives of charitable organizations revealed apprehension almost everywhere in the Bay Area but clear evidence of decline in corporate executive participation primarily in San Francisco, as shown in Exhibit 14.

Exhibit 14

PRELIMINARY IMPACT OF HEADQUARTERS LOSS ON CHARITABLE AND CIVIC PARTICIPATION

"Our leadership comes from the corporate community. When a company shifts its headquarters out of the Bay Area, taking top executives along, we lose key volunteers."

– Cultural organization A

"The donation of corporate in-kind time is critical for several of our operations, especially fund raising. Only two or three companies are still donating that kind of time."

– Cultural organization B

"More and more we are turning to middle management, and we don't get the penetration into major companies (for fund-raising) nearly as easily."

– Charitable organization C

Source: McKinsey interviews

RESTRUCTURING AS A NATURAL ECONOMIC PROCESS

Our findings concerning Bay Area corporate restructuring do not suggest an orderly progression from acknowledged problem, through clear diagnosis, to steps toward a solution. In particular, the fact that restructuring has had its clearest negative impact on San Francisco, within the healthy regional economy, raises an issue of focus. Either restructuring is a problem peculiar to San Francisco requiring a San Francisco solution, as some have suspected, or it is symptomatic of larger trends in the economy — which surface with some negative effects in the City, and neutral or positive ones elsewhere. Because this issue of focus is critical to deciding what, if anything, to do about restructuring, we paused to consider the wider economic context.

From a national point of view, restructuring appears to be more an instrument of change than a fundamental economic force in and of itself. It is more likely to be applied to maturing industries and to specific management situations than to geographic regions per se.

Not only does corporate restructuring appear to have done less harm to the Bay Area economy than generally acknowledged, it has played an important part in promoting overall economic change in our system — as one mechanism for allocating control of corporations and their assets. Such changes in control have always been present in the business life cycle, but shareholder action has recently brought them more out into the open, especially in conflict situations resulting in involuntary restructurings. The drama of human motivation in such conflicts gets the publicity, obscuring the straightforward function of corporate restructuring in facilitating economic change. Especially because of this instrumental role of restructuring in the ongoing process of economic renewal, we feel it is important to balance the record.

Restructuring as Means to Reallocate Corporate Assets

A corporation's stockholders share ultimate ownership rights to the assets of the corporation — whether machinery, plants, patents, regulatory permission to operate bank branches or sell insurance, timberlands, or cash. More important in practical terms, they have claims on the future earnings from the use or investment of the assets. In expectation of earnings, the shareholders delegate day-to-day use of the assets to a management group.

As a result, the value of owning shares is dependent on industry competitive circumstances, and the quality of management decisions. The comparative worth of

shares is established in the market every day. If shareholders decide that a firm's assets are being used in a less than satisfactory manner, they have two choices. They can sell their shares, or they can change management.

Changing management through restructuring has emerged more and more frequently in the last several years as a vehicle for allocating corporate assets to their most efficient and profitable use.[5] Restructuring is a mechanism of the market for control of corporate assets, which is a market just like any other one. XYZ Corporation's prospects of future earnings, when compared to other investment opportunities, establish or "ask" a certain price for the authority to manage XYZ. In principle, management teams "bid" for the rewards of exercising that authority. Current XYZ management bids implicitly, by continuing to perform in a manner satisfactory to the stockholders. Nowadays, however, it has become more common for rival or reconfigured management teams to bid explicitly, offering stock price premiums to the shareholders for the right to control XYZ — via mergers, acquisitions, and (as in the case of Safeway and Levi Strauss) leveraged buyouts.

Industry competition is a major driver of the market for corporate control. For example, companies in some industries (pharmaceuticals, automobiles) will suffer unless they learn how to manage through technological upheaval or achieve quality products at world economies of scale.[6] Other industries (aluminum, steel) have already decayed by not facing up to challenges like chronic overcapacity. Eventually, dying companies or industries will lose natural and human resources to new firms. These new firms will perform more effectively, promising better rewards to investors and — importantly — more sustained job opportunities to employees. In the current globalizing economy, the pace of this change is accelerating. The price exacted for management mistakes in resource allocation and operations will be higher, and it will be demanded more quickly.

Why are particular firms singled out for restructuring? One influential theory focuses on direct conflicts between shareholders and managers. The issue is the way "free cash flow" is spent. Free cash is defined as earnings or debt capacity a company enjoys, above and beyond its demonstrable prospects for profitably reinvesting in the firm's own operations.[7] Managers have incentives to use that cash and debt capacity to expand their firms, perpetuating their own control of the corporate assets — which may or may not be the best use of free cash from the shareholders' point of view. Indeed executives may never feel the consequences of their own decisions, unless they hold a substantial amount of stock themselves.[8]

Shareholders have a more detached perspective on resource allocation. Exposed as they constantly are to alternative investments in the global marketplace, stockholders are becoming increasingly unwilling to tolerate subnormal returns or expectations. Under normal circumstances, internal corporate supervision over

management, via the board of directors, works reasonably well. When it does not, a latent conflict of interest between management and shareholders emerges. Restructuring then becomes a serious option. It is the ultimate weapon to drive corporate assets to more productive uses — whether through an actual takeover, or through forcing management to reevaluate its plans in order to forestall open ownership struggle.

In several major Bay Area takeovers by firms outside the region, corporate assets were undeniably redirected to more profitable uses. The Crown Zellerbach takeover is an example. Industry average return on equity was 13.7 percent. Crown Zellerbach's reinvestment of its own free cash flow was substantial (at a level $80 million above inflation-adjusted depreciation). Yet average return on equity at Crown Zellerbach was only 3.4 percent. Sir James Goldsmith, interpreting this to mean that returns from Crown Zellerbach's assets might have underperformed their potential, bought the firm. He subsequently realized economies of scale in overhead, discontinued unprofitable reinvestment of free cash flow, and sold underlying corporate assets to other firms (James River Corporation in fine paper manufacturing, Mead in distribution) who were able to use them more profitably. Effectiveness and efficiency of production and marketing in those businesses are likely to improve substantially, as a result of the restructuring. In the end, Goldsmith's entry into the market for corporate control rewarded Crown Zellerbach's shareholders.[9]

The corporate control market has its imperfections, which are very controversial. Insider trading scandals, greenmail, and stock price speculation by arbitrageurs have angered many in management and among the public. Profound issues about long-term and short-term stakes in corporate ownership, public notification of intent to restructure, and the evolution of corporate law itself have been raised in recent Supreme Court decisions and in congressional testimony.[10] The Task Force does not take a position on any of these questions. By the same token, however, for purposes of appraising corporate restructuring in the Bay Area it is important to understand the powerful connection between the mechanism of restructuring and the fundamental forces of change in the economy as a whole.

In summary, corporate restructuring is not the randomly malignant process dominant in the popular imagination. The market values an individual firm's prospects on a comparative basis. In the last analysis, investors, as owners, can act on this valuation through the market for corporate control. Restructuring thus becomes an agent for change, prodding firms to performance consistent with the value of the resources they possess.

Dynamic Role of Restructuring In the Evolution of the Bay Area Economy

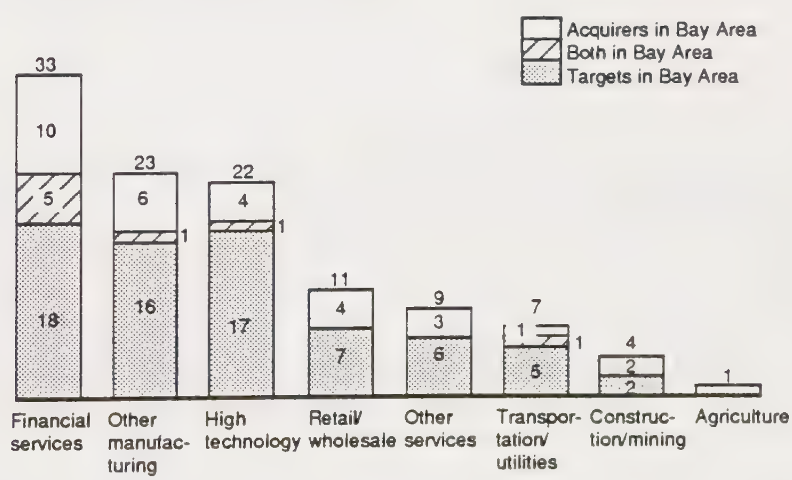
Public debate on restructuring in the Bay Area has focused almost exclusively on its disruptive effects. However, as the preceding discussion suggests, there is another side to the story of restructuring, which should be understood and anticipated rather than resisted at all costs. Restructuring has helped redirect assets controlled by Bay Area firms, following the market's drive toward more productive uses of capital and human resources. In this sense, Bay Area restructuring has — at least in part — functioned as a vehicle for economic change and renewal.

Bay Area restructurings in mature businesses have reflected general industry conditions, not regional peculiarities. In recent years, over 70 percent of Bay Area restructuring transactions greater than $50 million in value has taken place in the financial services, manufacturing, and high-technology sectors (Exhibit 15). For the period 1982 to 1985, a similar pattern has been shown in the U.S. economy as a whole, where the same sectors accounted for between 60 and 70 percent of high-value merger and acquisition activity.[11]

Exhibit 15

BAY AREA RESTRUCTURING BY INDUSTRY SECTORS – 1979-86

Number of transactions greater than $50 million



Source: Mergers & Acquisitions database; McKinsey analysis

The economic circumstances generally affecting Bay Area acquisitions in these sectors have been closely linked to overall industry trends (Exhibit 16). The trends make it difficult to assign responsibility for takeovers to regional economic weaknesses, as opposed to flawed managerial judgment or macroeconomic forces driving change in the structure of an entire industry.[12]

Exhibit 16

PROFILE OF BAY AREA CORPORATE RESTRUCTURING

	Economic circumstances affecting transactions	Links to overall industry trends
Financial services	– Larger transactions motivated by straightforward economics • Many sales due to financial distress or management inadequacy • Remainder mostly unwinding of previous diversifications, or new, occasionally questionable diversifications – Many smaller targets struggling or in receivership – Some genuine opportunities to create postacquisition value • Infusions of capital • Expansion of scope • Economies of scale • Reduction in expenses	– Major changes in industry structure precipitated by deregulation and interest rate fluctuations • Financial services companies eager to add to distribution networks and product lines • Other firms looking for diversification opportunities – Net employment outlook mixed • Some unambiguous consolidations echoing industry trend toward headcount reduction • Increased activity at successfully restructured firms possibly offsetting employment loss elsewhere
High technology	– Generally smaller companies with smaller transactions • Mergers facilitated by stock transfers • Transactions feasible in relatively short time frame – Genuine synergies possible • Ideas joined to capital • More informed acquisitions possible in limited-product-line firms	– High technology structurally vulnerable • Overcapacity, even saturation, in some sectors • U.S. firms frequently in high-cost position • Strategic options limited, especially in recent downturn – More consolidation virtually inevitable • Basis of competition changing: superior single-product technology no longer sufficient for business success • Firms often underleveraged, presenting relatively attractive acquisition targets
Manufacturing	– Many targets with underutilized assets • Asset reallocation deemed possible by some acquirers • Management sometimes able to recognize undervaluation and act via LBO – Some underperformers in their respective industries • Corrective action straightforward for new management • Interim tax carry-forwards attractive to some acquirers	– Consolidation/shrinkage of firms cutting across most manufacturing sectors • Uneconomic locations • Little prospect of regenerating large manufacturing industries

Some major Bay Area firms are better off because of restructuring. Bay Area corporations have also taken advantage of profit opportunities available from corporate restructuring. Chevron, through its acquisition of Gulf, addressed consolidation trends in the oil industry through rationalization of refining and distribution operations, and careful divestment of subsidiary units.[13] In this very substantial transaction, reallocation of assets through restructuring paid returns to Gulf shareholders and also strengthened a Bay Area firm.

Wells Fargo's acquisition of Crocker Bank is a second example. Controversial locally because of the elimination of duplicate jobs following the combination of the work forces, the restructuring has nevertheless been extremely effective in consolidating excess industry capacity, establishing a more efficient branch-banking network, and focusing on a California-oriented business strategy.

The Wells/Crocker transaction has been successful because it realized potential economic gains inherent in the changing deregulatory environment of financial services. These gains have been recognized in substantial returns to shareholders and high marks for Wells Fargo as a linchpin of the regional economy.[14]

Restructuring helps orderly growth of smaller firms. One significant concentration of local restructuring activity is in high-technology industries — particularly in smaller companies, with restructuring transactions between $10 million and $50 million in value.

Our hypothesis would be that most of this high-technology restructuring benefits the regional economy. Sometimes single-product firms achieve efficient scale by acquiring other firms with complementary products and distribution networks. In other cases restructuring enables entrepreneurs to cash out and realize rewards from innovation. They do so by turning over their assets (technological process, patents, knowhow, actual products at market, and sometimes even their own continued presence in the lab) to business people better able to bring them to their full economic potential. These "growing" functions have been critical to the evolution of high technology in the Bay Area during the last two decades. They have also been essential to the activities of the strong regional venture capital industry, whose business it is to nurture the efficient development of smaller companies. Finally, restructuring's reputation for being focused on the short-term and inimical to research and development seems to have little foundation in fact.[15] Bay Area high-technology companies would seem to run small risk of acquisition by potential acquirers foolishly inclined to destroy future earnings by shortchanging R & D.

THE NEED FOR A NEW ECONOMIC AGENDA

For at least five reasons, initiatives to influence the nature or results of restructurings in the Bay Area are likely to be misdirected, ineffective or counterproductive:

¶ The economic climate in the Bay Area has been very healthy — and not at the mercy of hostile restructuring transactions.

¶ Saving jobs from loss due to restructuring does not drive strong employment — job creation does so, on the basis of the underlying regional economy.

¶ Despite San Francisco's relatively difficult restructuring experience, there is little evidence that it differs from national trends — which exhibit restructuring throughout maturing and highly competitive industry sectors.

¶ Restructuring is a mechanism for the market's drive to allocate corporate assets efficiently — trying to stop restructuring implies trying to deflect a fundamental force in the national economy.

¶ Restructuring has encouraged growth in Bay Area medium and small businesses.

Little is to be gained by rallying public resources to the defense of mature companies, as a matter of policy. Achieving sustainable competitiveness in the first instance is the responsibility of management. San Francisco, especially, must avoid squandering its energy where it will be unlikely to help. <u>Restructuring is neither the core issue facing Bay Area business nor one that can be reliably influenced by local initiative</u>.

At the same time, intense, legitimate interest exists in helping individual firms and the Bay Area economy gain strength for the long term. To do so, priorities for study and action must be changed. We believe that the key issue is likely to be broad in scope and extremely challenging: <u>promoting regional economic vitality in an increasingly competitive and interlinked national and world economy</u>.

During the course of our study on restructuring, questions continually emerged that we believe will be important in setting the new agenda for Bay Area economic renewal:

1. <u>Is the Bay Area increasingly at risk of splitting into multiple economic regions</u>?

   Half the companies among the top 100 Bay Area firms in sales revenues during 1986 were high-technology firms. Furthermore, about 35 percent of the top 100 companies judged by return on equity were high-technology firms from Santa Clara and San Mateo counties.[16] If the Bay Area is going to depend still more heavily on high technology in the future, we had better understand what we can do to nurture its further growth. The aspirations of South Bay and East Bay business will obviously be critical in this process.

   Whether the Bay Area will split into multiple economic hubs is not yet clear.[17] However, San Francisco may already have relinquished its full

traditional role as the economic center of gravity of the Bay Area. Put another way, the City's position within the Bay Area economy may no longer be robust enough to duplicate the experience of New York City, which through sheer economic power survived corporate sprawl into exurban centers in Westchester County, southern Connecticut, and northern New Jersey. Restructuring of corporations here, on a much smaller base, raises the issue of whether San Francisco should become more economically specialized to weather the displacement of larger firms, or whether it in turn should try to renew its historical place in the regional economic system.

2. Can San Francisco meet its special challenge, on behalf of the Bay Area economy, to enhance the environment it provides for both its maturing business base and for emerging entrepreneurial firms?

   Every region's economy is fundamentally supported by wealth that is created by serving other regions (except where there are large stores of natural resources, which, since the passage of the Gold Rush, the Bay Area has notably lacked). Corporations serving national and international markets bring the dollars they create by selling outside the region to bear on the local economy. Tourism, too, provides support by importing dollars earned elsewhere. The success of local support businesses and retail establishments is fundamentally tied to the ability of the local economy to run a trade surplus, in effect, with other regions. Without the renewal of the base of corporations serving markets outside the Bay Area, the future of most locally focused businesses, small and large, will be increasingly dependent upon tourism and may face a gradual decline in fundamental demand.

   No one should be under the illusion that replenishing the corporate roster in any urban area is easy, given the complex economic and social conditions a new headquarters location must satisfy. This, however, is what San Francisco needs to accomplish, against some stiff competition. Furthermore, attracting new corporations from outside the region will be made more difficult because of the city's antibusiness image.

   A recent poll of 400 corporate CEOs and 201 senior real estate officers carried out by Louis Harris and Associates for Cushman & Wakefield reveals the contradictory quality of San Francisco's image among American business leaders.[18] On the one hand, 52 percent of them ranked the city an appealing place to do business today — third among a dozen U.S. cities, behind Atlanta and Boston. On the other hand, when executives were asked about hard business factors for relocation (proximity to markets, customers, clients, and raw materials, cost and

availability of labor, climate created by state and local government for business, availability of existing fully serviced sites, and quality of life for employees), San Francisco was rated third from the bottom — just ahead of Miami and Washington, D.C.

The Harris poll dealt with perceptions, rather than exact knowledge, on the part of the business executives surveyed. However, changing perceptions can be critical to the relocation process. San Francisco has many attributes that are attractive to business and many trends are actually quite favorable, but little has been done until very recently to educate the broader public. Few public or private resources have been devoted to this task, while San Francisco has borne the burden of numerous major articles emphasizing the negative. Furthermore, the specter of the AIDS epidemic raises special educational challenges for the city. Finally, the San Francisco executives we interviewed felt unanimously that the local media have failed to provide a balanced perspective on the region's economy.

3. Can a regional approach to economic growth and renewal be successful? If so, is there a practical way to begin?

   The rallying point for concern and cooperation could perhaps be regional economic development. The City and the region together certainly exert greater weight and prominence as a national productivity resource.

   Unfortunately, to date few have felt the need to look beyond the surface of "popular" economic issues such as corporate restructuring to gather a regional constituency. All too often in the Bay Area, the consequences of natural economic growth have been seen as problems to be mitigated, rather than challenges to ingenuity and leadership. All too often public activity has been limited to decrying change, rather than understanding it and working to harness its underlying forces.

   Many circumstances divert attention from the difficult initial step of creating a consensus on regional economic development. Probably the most visible of these is political. Public figures do not have a Bay Area regional franchise. Instead each leader is focused on a single city, a county, or the state as a whole. Consequently, not many in public office have seen any advantage to exerting wider regional leadership.

   For their part, interested private business groups often concentrate on issues of one locality to the exclusion of others. Sometimes, unfortunately, they also become embroiled in overlapping claims to

authority within their own communities. In regional matters, even in groups like the Bay Area Council, there tends to be only limited involvement of leaders from outside San Francisco. All of this wastes energy and discourages consensus rather than creating a basis for it.

Much more must be done. An early task will be to analyze the economic rationale for an area-wide approach to growth and renewal. Just as important, however, will be to begin a regional economic dialogue. The Task Force hopes that its study of corporate restructuring will encourage the Bay Area Council, and others with a regional vision, to seize the initiative and refocus public debate on the real issues at hand.

June 9, 1987

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1 Estimates were calculated using the Input-Output Tables for the Bay Area Economy (1982), (Oakland: Association of Bay Area Governments, 1986).

2 Projections — 85: Forecasts for the San Francisco Bay Area to the Year 2005 (Oakland: Association of Bay Area Governments, 1985), p. 33.

3 See Raymond J. Brady, "Intraregional Economic Linkages of the High Tech Industry in the San Francisco Bay Area", (Oakland: Association of Bay Area Governments, 1986).

4 "Bay Area Charities Feel Pinch," San Francisco Examiner & Chronicle, May 3, 1987.

5 See Michael C. Jensen, "The Takeover Controversy: Analysis and Evidence", Midland Corporate Finance Journal 4:2 (1986).

6 See Richard N. Foster, Innovation: the Attacker's Advantage (1986), and Kenichi Ohmae, Triad Power: The Coming Shape of Global Competition (1985).

7 Jensen, "The Takeover Controversy."

8 T. Boone Pickens, "The Effects of Corporate Restructure on American Business", Executive Dialogue Series (General Electric Credit Corporation, San Francisco, December 3, 1986).

9 Jonathan B. Levine, et al., "The Crown Zellerbach Deal Could Make Everybody Happy," Business Week, December 30, 1985, p. 53.

10 See, for example, testimony before the Subcommittee on Economic Stabilization of the Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, May 12, 1987.

11 Mergers & Acquisitions almanacs, 1983-86.

12 See testimony of David T. Scheffman, Director, Bureau of Economics, Federal Trade Commission, before the Subcommittee on Economic Stabilization of the Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, May 11, 1987.

13 Bob Williams, "Chevron's Restructuring Spurring Innovation," Oil and Gas Journal (November 18, 1985). Kathleen Wiegner, "No regrets," Forbes (March 10, 1986). Wall Street Journal (November 11 and December 13, 1985).

14 Richard B. Schmitt and G. Christian Hill, "Wells Fargo's Crocker Merger Pays Off Bigger and More Quickly Than Expected," Wall Street Journal (October 22, 1986).

[15] See, for example, R.S. Belous, "The Impact of Mergers and Acquisitions on Labor Markets," Hearings of the House Subcommittee on Employment and Housing, Committee on Operations, March 31, 1987. However, The Securities and Exchange Commission's Chief Economist has found evidence directly contradicting the notion that merger and acquisition activity tends to sacrifice research and development in favor of short-term returns (Securities and Exchange Commission, Office of the Chief Economist, "Institutional Ownership, Tender Offers, and Long-term Investments," April 1985).

[16] "Business Extra Special Edition: The Chronicle 100", San Francisco Chronicle, March 30, 1987. See also Raymond J. Brady, "Intraregional Economic Linkages".

[17] See Raymond J. Brady, "The Changing Structure of the Bay Area Economy: Interdependence not Independence," (Oakland: Association of Bay Area Governments, 1987).

[18] Cushman & Wakefield, Inc., "Business America Real Estate Monitor," December 1986.